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SENSITIVE

STATE PASS USTR FOR KDUCKWORTH
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TAGS: ECON EFIN EINV ETRD BR
SUBJECT: WHY IS BRAZIL'S COST OF CREDIT SO HIGH?

REF: Sao Paulo 280

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

¶1. (SBU) Summary: Consumers and businesses pay more for loans in Brazil than they do in almost any other country, with average interest rates on credit cards of 200 percent and some of the highest banking spreads in the world. While the GOB blames banks (and vice-versa) for the high real interest rates, both parties share responsibility. Analysts believe that to reduce high interest rates, banks should first centralize consumer credit history data, and thus reward clients with a good credit history with lower rates. End Summary.

200 Percent APR

¶2. (SBU) At 35 percent, Brazil has the highest commercial banking spread in the world (i.e., the difference between the interest rate banks pay depositors and what the banks charge businesses and consumers), according to a March report from the Institute for Industrial Development, a lobby group. Despite the BCB's relatively low overnight lending rate (known as the SELIC rate) of 9.25 percent, consumers pay an average interest rate of over 200 percent on credit cards, according to Fernando Valim, President of Experian/Serasa, the only significant credit rating agency in Brazil. Secured loans fair somewhat better-- consumers paid an average of 132 percent per year and businesses paid 63 percent, according to a May report from the National Association of Finance, Business, and Accounting Executives (ANEFAC). Depositors by law currently receive 0.55 percent per month on their savings account deposits, minus a substantial bank fee, which varies by bank.

¶3. (SBU) Some economic sectors, such as farmers and small businesses, receive loans sharply discounted by government mandate. Private bank sources say, however, that banks pass on the cost of these government-mandated, lower interest rate loans to their other clients. Consumers can also receive discounted loans for real estate purchases through the GoB-owned Caixa Economica.

¶4. (SBU) In a competitive market, if one bank offered a loan for less than another, other banks would be forced to lower their interest rates. Brazilian credit, however, does operate in a

sufficiently competitive market to allow for this. Because positive credit history is not centralized, clients must build a relationship with just one bank, usually the one that focuses most on their individual needs. For example, government-owned Banco do Brasil has previously concentrated on agricultural loans, so construction companies have historically looked to other banks for their own financing. If a company or individual were to try to take advantage of a lower interest rate offered by another bank, they would have to answer questions about why they have left their old bank, filling out myriad forms, and ultimately receive a smaller loan than they would have gotten from their original bank. Since banks effectively lock in their customers, price differences for loans from one bank to another do not create a strong downward pressure on the spread.

¶5. (SBU) Another obstacle to lowering the spread, according to Valim, is the inability of creditors to enforce contracts when consumers default on their debts. Consumer protection laws make repossession so cumbersome that most banks prefer to write off their losses in the event of default. A 2007 Brazil Central Bank (BCB) study detailing the costs of the spread supports Valim's assertion. The high default rate is responsible for 37.4 percent of cost of the spread. The bank's margin ranks second at 26.9 percent of the spread. And government taxes are third with 18.3 percent.

¶6. (SBU) Brazil's high interest rates increase the risk of default, according to Yoshiaki Nakano, Director of the Economics Department at the Getulio Vargas Foundation. Companies choose to invest in a project only if it will earn more than government-backed securities plus a risk premium. Since interest rates in Brazil are so high (currently at 9.25 percent, actually an historic low), an investment

project will need to earn a very high rate of return to make it worthwhile. It will also carry with it a correspondingly high risk of failure. Banks thus charge an even higher rate to compensate for increased risk. The inverse is also true--with interest rates in Brazil falling, Nakano believes the spread will fall at an even faster rate.

A Solution to Default...

¶7. (SBU) The high default rate is primarily a result of weak contract law, according to former BCB Deputy Governor Luiz Fernando Figueiredo. To help lower the interest rates for good consumers, Figueiredo introduced conditional sales contracts to Brazil ("alienacao fiduciaria") during his tenure at the BCB. Under a conditional sale, a consumer buying on credit can take possession of a good, but the actual title remains with the bank until the item is fully paid (similar to car loans in the United States). Buyers who default are required to return the purchased item to the bank or face prison. The fact that banks can repossess leads to lower risks for banks and thus lower interest rates for consumers. It has helped significantly to lower the interest rate for loans in the real estate sector, for example.

...Undermined by Judicial Intervention

¶8. (SBU) The courts have invalidated conditional sales contracts in some sectors by blocking banks from repossessing goods. In the state of Mato Grosso, for example, farmers who could not make payments for their agricultural equipment took their case to court and won the right to keep their goods, despite being in default. Consequently, banks no longer offer conditional sales contracts for agricultural equipment. The future of this innovative system is in jeopardy, as well, according to Figuerido. Since Brazilian courts follow Roman law-based judicial norms, judicial precedent does not bind judges' decisions. They reinterpret the law in every case, and a capricious judge could decide to end conditional sales contracts in any sector he or she chose.

A Credit Score of Zero

¶9. (SBU) Boosting positive data flow to the credit markets, i.e., undertaking a scoring system similar to the United States, would also help lower the spread, according to Valim. The banks themselves constitute the principal barrier to such a system. Flush with cash from their 26.9 percent profit margin, banks would prefer to lock in customers rather than lose them to other banks, so they closely guard data on their costumers' lending history. If they shared this information, well-informed consumers could arbitrage the difference in rates, force down the spread, and cut into the banks' high profit margins.

¶10. (SBU) The lower house of the Brazilian Congress approved legislation on May 19 that would create a centralized system to track positive credit, i.e., a positive credit bureau. The Senate still needs to approve the law. Director-General of the Brazilian Banking Association (Febraban) Wilson Levorato called the lower house's passage "an historic moment" in a press interview. He said that 95 percent of consumers pay for the five percent who default and that this legislation is the first step to addressing this disparity. Consumers who opt-into this new voluntary system would have their credit payments tracked. Those who prove good credit history eventually would pay lower interest rates on loans, though it would take some years to build their credit score. Valim actually opposes the legislation, telling EconOff that it has been so heavily amended that it would actually impede credit expansion. (Note: If the Senate passes this legislation and President Lula eventually signs it, there would be no need for Experian/ Serasa to continue operations. End note.)

¶11. (SBU) Comment: While Brazil's untapped credit market has held back growth, it has also has been the country's greatest defense against the ongoing financial crisis. Banks have not had to dabble in higher risk activities, such as mortgage-backed securities and other toxic assets, because straightforward loan portfolios are so profitable. This profit margin has infuriated President Lula and led him to publicly attack private banks. His self-described "obsession" with lowering the spread may have led Lula to try to force the state-owned Banco do Brasil to lower banks' profit margins on loans (reftel), but a more effective, though politically more challenging, approach to pushing down the cost of credit would be to lower taxes on banks, which could then pass those savings along to consumers and businesses. End Comment.

¶12. (U) This cable was coordinated with and cleared by the Treasury Financial Attache and Embassy Brasilia.

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